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That ’70s Look: Stagflation

By Graham Bowley
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Lately, many people are hearing an echo — faintly perhaps but distinctly audible — of the stagflation of the 1970s.

Even as economic growth sags, oil and gasoline prices are surging to new heights. Gold is on the rise, along with the prices of such basic commodities as wheat and steel. And on Wednesday, with the latest government report on consumer prices, there are signs that overall inflation, after years of only modest increases, may be breaking out of its box.

For the Federal Reserve and its chairman, Ben S. Bernanke, all this could not come at a worse time. With the credit markets in disarray from the collapse of the housing bubble, Mr. Bernanke is cutting rates in a headlong rush to blunt the risks of recession.

But in putting its emphasis above all on reviving growth, America’s central bank, according to some economists and even a few Fed officials, may face a bigger inflation problem down the road.

“They are cutting rates with a bill to be paid later," said John Ryding, chief United States economist at Bear Stearns. “The question is not, will we get inflation, but how much will it cost to stuff the genie back in the bottle. This has the feel of 1970s stagflation.”

Over the last 12 months, consumer prices are up 4.3 percent on average, according to the Labor Department. The core index of consumer price inflation, which excludes food and oil, was 2.5 percent higher in January than a year earlier, significantly above the Fed’s unofficial comfort zone of a 1 to 2 percent underlying inflation rate. That’s a far cry from the double-digit inflation rates that battered the economy at times in the 1970s, but still worrisome.

Analysts like Mr. Ryding say that by tolerating such price rises and maybe even allowing them to escalate, the Federal Reserve is risking its hard-won credibility as an inflation fighter, which will ultimately require it to push up interest rates higher than otherwise to contain the damage.

Most economists still expect the Fed's policy-making committee to cut interest rates again when it meets on March 18, engineering its sixth reduction since September. But the fears of a revival of inflation underline the difficult decisions it now faces.

Like the Fed, economists generally remain more concerned about the immediate threat of recession than the more distant fear of higher inflation. Recent data suggests an economy that may be in a downturn or close to it. The consensus view is that the expected slowdown is likely to create enough spare capacity to suck inflationary pressures out of the economy.

Moreover, even if some additional inflation is a side effect of the Fed's prescription, many economists say, it sure beats the alternative. Once the interest rate cuts have nursed the economy through the next few difficult quarters, they say, the Fed can easily raise rates again to respond to any pickup in inflation.

"They are going to fix the wound now," said David Durst, chief investment strategist of the Global Wealth Management Group of Morgan Stanley. "They are going to take care of the growth situation and then fight inflation when the economy gets stronger."

Reinforcing this view, there are few signs that inflation is seeping into the labor market and pushing up wages in anticipation of higher prices to come.

That may be comforting to the Fed, but keeping inflation contained still may not be easy. In recent days some officials at the central bank have gone out of their way to warn that they are not prepared to let down their guard — even if it means that the Fed has to be less aggressive about cutting interest rates.

In a speech this month, Richard W. Fisher, president of the Federal Reserve Bank of Dallas, said "the Fed has to be very careful now to add just the right amount of stimulus to the punch bowl without mixing in the potential to juice up inflation once the effect of the new punch kicks in."

Charles I. Plosser, president of the Federal Reserve Bank of Philadelphia, echoed that view, saying in a speech that “we cannot be confident that a slow-growing economy in early 2008 will by itself reduce inflation.”

“As we learned from the experience of the 1970s,” Mr. Plosser added, “once the public loses confidence in the Fed’s commitment to price stability, it is very costly to the economy for the Fed to regain that confidence.”

In a telephone interview, Mr. Plosser explained that the Fed seemed to be making progress against inflation in the first half of 2007 but he started to become more worried during the second half.

“Since the summer almost all of the measures of inflation that we look at have begun to accelerate again, and in some cases pretty sharply,” Mr. Plosser said. “Perhaps the inflationary pressures are more broad-based than just energy.”

While Mr. Plosser said he hoped that inflation was about to moderate on its own, “we do have a dual mandate after all — one is price stability and the other is growth.”

“We can’t just throw one out of the window when it is convenient.”

To Bernard Baumohl, managing director of the Economic Outlook Group, such talk is seen on Wall Street as a clever tactic intended to help jawbone inflationary expectations downward while the Fed continues to cut rates for at least a while longer.

“We expect Fed officials will ramp up their rhetoric in speeches and in testimony that they will work diligently to keep inflation expectations under control,” Mr. Baumohl wrote to clients after the latest consumer price figures were released Wednesday. “Mere words, to be sure. But it would be a mistake to construe them as hollow.”

Zach Pandl, an economist at Lehman Brothers, said that the statements so far have been by less important Fed officials and that the Fed’s real views should be measured by its actions, which are to cut rates aggressively with less concern about inflation.

Those actions have led a number of economists to warn that the Fed's aggressive easing moves, combined with the strong demand for industrial and agricultural commodities from emerging global economic powers like China and India, may be laying the groundwork for a new era of rising inflation.

"The period of falling inflation that we have been in for all the '80s and '90s and early 2000s has come to an end," said Michael Darda, chief economist at MKM Partners, a research and trading firm in Greenwich, Conn. "That is over."

Mr. Darda points to the surge in commodity prices, including food and oil. Long-term rates are rising in the bond market, reflecting the view that both growth and inflation may pick up later this year and into 2009, as well as fears about bad debt.

And, according to Mr. Pandl, a measure of investors' inflation expectations provided by the difference between the yield on normal Treasury securities and Treasury inflation-protected securities "spiked quite a bit higher" after the Fed cut rates in January even though it "has been trading lower since then."

Then there is gold, which has historically been a refuge for investors seeking protection from eroding currencies.

Gold "has risen a lot since the Fed began lowering rates," Mr. Darda said. "That's an ominous sign. Once we are in 2009 and 2010, we are going to figure out that inflation is far less benign."